

Chapter IV

Internal Controls

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Introduction

The Committee of Sponsoring Organizations (COSO) of the Treadway Commission defined internal control as “a process effected by an entity’s board of directors, management and other personnel, designed to provide reasonable assurance regarding the achievement of objectives in the following categories: effectiveness and efficiency of operations; reliability of financial reporting; and compliance with applicable laws and regulations.” According to COSO, the internal control environment of an organization includes the plan of organization, policies, procedures, and systems used by management to provide reasonable assurance that its goals and objectives are met; that resource use is consistent with laws, regulations and stated policies; that resources are reasonably safe-guarded against waste, loss and misuse; and that reliable information is obtained, maintained and fairly disclosed in reports to management.

The SBC/Ameritech Merger Investigation was performed in accordance with Generally Accepted Government Auditing Standards applicable to performance audits. These standards are set forth in the booklet entitled *Government Auditing Standards, 1994 Revision* promulgated by the Comptroller General of the United States. As more fully explained in Chapter II, these standards pertain to the qualifications of the auditor, the planning and supervision of the engagement, the conduct of fieldwork, and the reports that are written after the fieldwork has been completed. For this engagement, we evaluated Ameritech internal controls pertaining to the organizations, systems and procedures established to ensure that affiliate transactions, cost allocation and merger related costs and savings are reported in accordance with Commission requirements. The results of this review are summarized in the Internal Control Checklist that appears in Exhibit IC-1 on page 3 of this chapter of the report.

Objectives

- Determine whether SBC, Ameritech and AI management has informed Company personnel of each revision to the CAM, provided easy access to the revised manual and trained its employees in its proper application.
- Determine whether SBC and Ameritech have established appropriate organizations and clearly assigned management responsibility for regulatory compliance in areas within the scope of this investigation.
- Determine whether SBC and Ameritech have developed and communicated appropriate Codes of Conduct and established procedures for communication with employees, reporting violations and following-up on exceptions.
- Determine whether SBC and Ameritech executive compensation and management employee incentive programs include provisions that provide incentives for the achievement of merger related savings.

- Determine whether Ameritech executive compensation and management employee incentive programs are properly aligned with quality of service performance standards established in the alternative regulation proceedings before the Commission.
- Determine the scope of internal and external audit work relating to CAM compliance and cost allocation and the adequacy of management procedures in place to address audit findings and recommendations.
- Determine whether systems and procedures used for cost allocation and the reporting of merger related costs and savings are well designed, documented and operating effectively to accomplish their purpose.

Evaluative Criteria

- Are Ameritech and AI employees adequately informed of CAM and merger related regulatory requirements and are training programs in place to reasonably ensure compliance?
- Have the companies clearly defined organizational responsibility for CAM and merger related regulatory compliance and is there adequate continuity of experience in these areas as the organizations have changed with implementation of the merger?
- Have the companies developed Codes of Conduct and established procedures for communication with employees, reporting violations and following-up on exceptions?
- With implementation of the merger, are there proper incentives and an absence of disincentives for maintenance and improvement of quality of service standards under alternative regulation while merger savings are being achieved?
- Has Ameritech established an appropriate internal and external audit program relating to CAM compliance and cost allocation including management procedures relating to implementation of audit recommendations?
- Are systems and procedures used for the reporting and allocation of merger related costs and savings integrated with the corporate financial accounting systems to provide a similar framework for the consideration of internal controls?

Summary of Audit Procedures

- Reviewed relevant SBC and Ameritech documents including:
 - ⇒ Organization charts of organizations responsible for CAM compliance
 - ⇒ The Ameritech Code of Conduct
 - ⇒ Executive Compensation and Management Incentive Plans
 - ⇒ Internal Audit Work Plans and selected audit reports
 - ⇒ An FCC audit of AI Cost Allocations
 - ⇒ Accounting systems documentation

- Reviewed merger related communications with employees and the scope of training programs relating to CAM compliance.
- Reviewed procedures relating to the reporting and investigation of possible violations of the Code of Conduct.

**Exhibit IC-1
Internal Control Checklist**

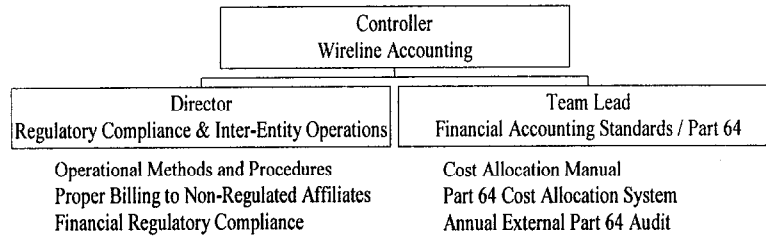
Internal Control Preferred Practices	Appropriate Control Environment	
	Yes	No
Organization		
• Executive management commitment to internal control and regulatory compliance	X	
• Management organization providing adequate direction and oversight	X	
• Job descriptions reflect accountability for compliance	X	
• Adequate separation of duties	X	
• Effective communication to address problems and avoid mistakes	X	
• Adequate training programs for responsible employees	X	
• Continuity of experience and knowledge in staff	X (Conclusion 2)	
• Organization responds promptly to change and produces timely updates to the CAM	X	
Systems and Procedures		
• Procedures relating to CAM compliance and documentation are adequate	X	
• Codes of Conduct and related compliance programs are adequate	X	
• Cost allocation systems are adequately documented	X	
• Changes relating to cost allocation are adequately documented, tested and controlled	X (Conclusion 11)	
• Merger cost and savings systems are integrated with the financial accounting systems and are adequately designed and documented to ensure compliance		X (Conclusion 12)
Internal/External Audit		
• Internal audit plan incorporates periodic CAM compliance audits and provides for appropriate follow-up	X	
• Internal audit resources are adequate including professional personnel with appropriate certification, training and experience	X	
• Independent audits are performed in accordance with regulatory requirements and management initiates corrective action on findings	X	
• Annual FCC reviews confirm compliance in all material respects		X (Conclusion 11)

Note: References to conclusions are for elaboration or to describe exceptions. When no conclusions are referenced, BWG determined that internal controls in the area are adequate.

Findings and Conclusions

1. In response to ICC and FCC requirements, SBC has established a high level Merger Compliance organization and is actively monitoring its performance against the compliance stipulations contained in the respective merger orders.
 - In November 1999, the Company appointed a Senior Vice President – SBC Compliance who reports to the Executive Management Committee and the Audit Committee of the Board of Directors.
 - Approximately 24 individuals are assigned to the Compliance Organization with responsibility for monitoring the performance of the “accountable officers” in the line organization who have been assigned responsibility for merger compliance.
 - The Company maintains an Illinois Merger Stipulation Agreement Report that is updated on a bi-weekly basis for tracking ICC Merger Commitments against the milestone schedules established. The report dated June 2, 2000 reflects 120 specific ICC Conditions that have been assigned to approximately 15 accountable officers. Of the 121 assignments, 54 were completed and 67 are shown as being on target for completion against milestone dates in the future.
2. Ameritech currently has an appropriate, experienced organization in place to control the cost allocation process and ensure CAM compliance. However, it is likely that the experience level in organizations responsible for CAM compliance will be affected by the reorganization and consolidation resulting from the merger.
 - Currently, the Cost Allocation Process is primarily controlled by two centrally managed organizations with experienced personnel, as shown in Exhibit IC-2 below.
 - Existing position descriptions adequately address responsibilities for affiliate transactions, cost allocation and other regulatory compliance issues.
 - ⇒ The planned consolidation of CAM management in St. Louis may result in downsizing or attrition that could increase spans of control and weaken existing capabilities.
 - ⇒ The assignment of current management personnel to focus on the Alt. Reg. proceedings may diminish oversight of the cost allocation process.

Exhibit IC-2
Organizations Responsible for the Cost Allocation Process

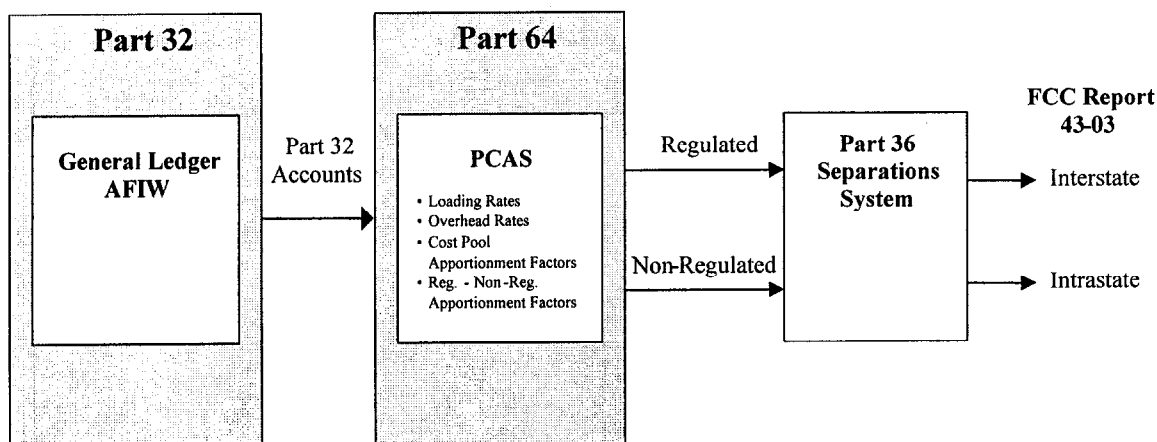


Source: Ameritech Organization Charts (Data Request IDR 5); Position Job Descriptions (Data Request WJD 2.1).

3. Ameritech has developed appropriate controls over the cost allocation process.
 - The 1999 internal audit of the 1998 cost allocation process found the overall system of internal controls to be effective.
 - External audits found the overall control environment to be sound.
 - BWG's testing of cost allocations is described in Chapter VI of this report. No significant exceptions are noted.
4. Ameritech has developed and implemented an appropriate process to ensure compliance with FCC requirements regarding revisions to the Ameritech Cost Allocation Manual (ACAM). Merger-related changes to the ACAM were appropriately implemented using Ameritech's standard ACAM revision process.
 - The Financial Accounting Standards/Part 64 Organization determines the need for revisions to the ACAM and files updates annually.
 - Revisions are based primarily on FCC Orders and Directives; additional or eliminated affiliates; changes in non-regulated activities; organizational changes; financial standards revisions; and business unit input.
 - The Company has a formal process to communicate changes to the ACAM to the appropriate responsible employees. After the revised ACAM is filed with the FCC, Ameritech distributes the revised ACAM and a letter detailing the changes to all business unit representatives and CAM contact personnel at non-regulated affiliates.
 - Merger-related changes to the ACAM were included in Ameritech's December 6, 1999 update.
5. The Company has a well-documented Cost Allocation system called the Part 64 Cost Allocation System (PCAS). Ameritech created this system to properly allocate costs between regulated and non-regulated activities and to pass these costs to Ameritech's Separations System for use in preparing the FCC ARMIS Joint Cost Report 43-03.

- An overview of the Cost Allocation process is provided in Exhibit IC-3.

Exhibit IC-3
Cost Allocation Process Overview



Source: BWG Analysis

- PCAS is a table driven mechanized process, which determines Cost Pool apportionment and regulated, non-regulated assignment.
 - Experienced employees verify changes to PCAS and validate the programmed calculations which are performed by the system internally.
 - As noted in the Regulatory Compliance segment of the audit, the PCAS documentation binder shows a revision date of May 1, 1995 and should be made current.
6. Although the SBC Executive Compensation and Management Incentive Plans do not specifically contain performance standards relating to service quality or the achievement of merger savings, existing performance standards are not in conflict with the Commission's requirements in these areas.
- Since 1995, Corporate and Business Unit financial performance have been the only factors measured under both the Ameritech and SBC Executive Compensation and Management Incentive Plans.
 - There is no direct linkage between the Executive Compensation and Management Incentive Plans and the eight service measures contained in the alternative regulation plan for the tracking and monitoring of AI's performance: (1) percent installation within five days, (2) trouble reports per 100 access lines, (3) percent out of service over 24 hours, (4) percent dial tone speed within three seconds, (5) operator average speed of answer – toll and assistance, (6) operator average speed of answer –

information, (7) operator average speed of answer – intercept, and (8) trunk groups below objective.

- Financial performance targets for 2000 are based on budgets that incorporate net savings expected to be achieved in the merger.
 - SBC Executive Management and the SBC Executive Compensation consultant believe that service quality must be achieved to ensure continuing improvement in the Company's financial performance.
7. Both the Ameritech and SBC Codes of Conduct provide adequate information and guidance to employees regarding legal and ethical behavior in a wide range of business situations. Merger related issues are adequately addressed in sections relating to Compliance with FCC Regulations for all employees and in supplements to the Codes of Conduct for others on a jobs related need to know basis.
- The Ameritech and SBC Codes of Conduct are maintained separately although there is a “blending” effort in progress. The Codes of Conduct are available to all employees on the companies' websites.
 - Procedures require that all employees provide an annual acknowledgment to their supervisors that they have read the Codes of Conduct. Employees are directed to read the code, sign an acknowledgment page and forward it to their supervisor for inclusion in their personnel files. It is the supervisor's responsibility to ensure that their employees fulfill this obligation.
 - The Code of Conduct contains information on how to report violations of the Code. BWG determined that the instructions relating to the reporting of violations include working phone numbers which were appropriately answered.
8. Although the Codes of Conduct provide explicit instructions to employees regarding the requirement to return an acknowledgement form annually, there are a number of employees who have not complied with this requirement.
- Internal audit regularly tests compliance with the procedure that requires all employees to return acknowledgement forms indicating that they have read the Code of Conduct. In the most recent audit relating to PacBell, based upon a sample of 66 employees, the auditors found a 15 percent exception rate consisting of missing acknowledgement forms and persons returning the forms who later stated that they had not actually read the code.
 - BWG selected a sample of 23 Ameritech employees and found that eight had not completed Acknowledgement Forms within the past year. Forms that were provided by the Company for the eight employees were executed following the date of BWG's data request.

9. Both SBC and Ameritech have procedures relating to the investigation of violations to their Codes of Conduct and maintain reports to ensure that disciplinary action against violators is consistent and appropriate.

[All finding and exhibits supporting this conclusion are confidential]

10. Ameritech's internal audit organization is appropriately staffed and has developed an audit plan that adequately addresses the cost allocation process. The Company has taken appropriate corrective actions in response to audit findings.
- The Internal Audit Staff (IAS) performs annual attest audits to determine whether the system of internal control related to Part 64 and PCAS is adequate. The attest audits incorporate the results of external audits of ACAM and PCAS and the status of corrective actions in response to external audit findings. Exhibits IC-5 and IC-6 (pages following) provide a summary of external audit findings regarding the 1998 and 1999 CAM as well as corrective action taken by the Company.
 - The IAS consists of 101 professionals who perform or manage internal audits as outlined in the IAS Annual Audit Plan.
 - It is IAS strategy to hire experienced, certified professionals. Currently the organizational profile reflects 58 percent Certified Public Accountants and 38 percent of staff members with other certifications, including CIA, CISA, CMA, CFE.
11. There are no readily accessible auditing tools available to test PCAS transactions. An FCC review of a PCAS external audit found compliance testing weaknesses.
- The Company has no PCAS output reports that facilitate the tracing of cost allocations from beginning to end. Changes in the Part 64 Cost Allocation System are verified via manual computation.
 - Absent a set of well documented tools to test that PCAS allocations are in compliance with the CAM, the loss of the experienced employees who currently validate results would weaken internal controls.
 - The FCC identified deficiencies related to this issue in Arthur Andersen's 1997 CAM audit, and as a result the FCC could not confirm Ameritech's compliance with Section 64.901[c] of the FCC rules. In response to the FCC finding, Ameritech disagreed, stating that the annual audit of the CAM is sufficiently comprehensive to ensure that Ameritech complies with Section 64.901[c].

Exhibit IC-5
Arthur Andersen Audit of the 1998 CAM
(Dollars in Thousands)

CONFIDENTIAL

Exhibit IC-6
Ernst & Young Audit of 1999 CAM (March 29, 2000)
(Dollars in Thousands)
CONFIDENTIAL

12. As more fully discussed in Chapter VIII, Merger Integration Teams, the Company is using a stand-alone database to accumulate and report merger costs and savings. This is a user-based system that is not integrated with the financial accounting system and is therefore outside the Company's established system of internal control.
- The Oracle Database System was developed by the Company as a management tool to assist in the monitoring and reporting of the achievement of merger savings against the established plan.
 - The Oracle Database System is not an accounting system and does not have the kind of controls that are inherent in a double entry accounting environment. Merger team personnel and MIT analysts use the on line entry capability of the system to enter cost and savings information obtained from a variety of sources. These include:
 - ⇒ Reports generated by the accounting system including payroll and accounts payable distribution reports.
 - ⇒ Reports generated by operating systems such as those used to record the number and duration of telephone calls.
 - ⇒ Merger related management reports such as those relating to employee severance.
 - ⇒ Merger related consultant reports including actuarial studies and third party audits.
 - Although the Oracle Database System performs adequately in accordance with its design, it will not be used for allocation of savings to Illinois, and raises other internal control issues that BWG has considered in the development of the work plan relating to the verification of the merger integration team process described in Chapter VIII.

Quantified Results of Investigation

Not applicable to this chapter.

Recommendations for the Company

1. Monitor timely receipt of employee Code of Conduct Acknowledgement Forms more closely. This can be accomplished by requiring supervisors responsible for obtaining Acknowledgement Forms from employees in their areas of responsibility to submit summary schedules of forms received annually to the Director of Compliance in the Human Resources Department. (Refers to Conclusion No. 8)
2. Develop mechanized tools to facilitate testing of PCAS to ensure the proper allocation of costs between regulated and non-regulated accounts (similar to that available for the Separations System). This would provide employees as well as internal and external auditors a readily accessible testing mechanism and audit trail to validate compliance with FCC and ICC cost allocation rules. (Refers to Conclusion No. 11)

Policy Issues for the Commission

None

Future Audit Issues

None